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"Even in such a time of madness as the late 1920s, a great many men in Wall Street remained quite sane. But they also remained very quiet. The sense of responsibility in the financial community for the community as a whole is not small. It is nearly nil."

J.K. Galbraith, The Great Crash 1929, p. xxi

HIGHLIGHTS

Do recent market calamities mark the beginning of the end? Financial markets, led by crashing bond markets, have been shaken everywhere. It's possible that the mania — the great financial bubble of the 1980-1990s — may finally have started its bust.

What is so lamentable, we find, is that so very few were able to recognize the build-up of the bubble, the biggest on record, and one that was so easily traceable through widely available statistics. Unwittingly, the poor private investor will bear the greatest pain.

As we have so consistently argued in these letters, the epicentre of this bubble was in the U.S. bond market, instigated and nurtured by an over-easy Fed. Prolonged, super-low interest rates have led to an overspeculated financial system, spreading troubles to the world's financial markets.

To be sure, there will be great efforts to resuscitate financial markets by policymakers and members of the financial system in upcoming weeks and months. Expect volleys of calming pronouncements and professed surprise over what happened in recent weeks.

Can the central banks restore order, perhaps by reducing interest rates? At best, it would only delay the ultimate outcome. The hard truth is that the greatest financial and economic disasters in history have generally been courted by prolonged periods of abnormally low interest rates.

We wonder if the next banking crisis is already under way. Bond losses for some banks must already be large. Even more worrisome, many banks have huge exposures to the derivatives markets. Rumours are thick.

What makes a bubble? The key gauge is the source of the funds flowing into the financial markets. Are they new savings or "inflation" derived fund flows? We again show conclusive evidence of the "inflationary" source of funds.

It's possible that minor recoveries will take place in both stock and bond markets. But, we're inclined to think that the great bullish tide of the bubble has crested. The general trend for most equity markets and the overleveraged bond markets will be down. How fast? It will depend on how well the financial system can hold together.

For investors, as we have repeatedly emphasized, liquidity remains all important. Short-term bonds in the hard-currency markets and cash-equivalent investment remain the recommended harbours for conservative investors.

1929, 1987 OR WORSE?

It was always our suspicion: that an impending financial crash, most likely of global proportions, would find its trigger in the U.S. bond market. There were always other possible triggers, but the U.S. bond market was the epicentre from which the entire global mania of the past two to three years has radiated. It used to be that bond investments were thought only appropriate for widows, orphans and pensioners. But a totally different game has prevailed ever since the U.S. Fed embarked on a desperate mission to rescue the banking system and "jump start" the U.S. economy. By relentlessly reducing interest rates and maintaining super-low U.S. short-term interest rates over a prolonged period, the Greenspan Fed was instrumental in producing reckless inflation in the global stock and bond markets alike.

The U.S. bond market, considered to be the most liquid in the world, has nonetheless witnessed a near-crash, its tremors reverberating into the farthest corners of the globe. It was a risk we warned about repeatedly in these letters. And, we think it is only the beginning of troubles. Although financial markets may attempt minor recoveries in coming weeks and months, we think that the great speculative tide of the 1980-1990s, much larger than even experienced in the 1920s, has crested. From here on, financial markets, we expect, will be labouring against a strong undertow. Why? It's the nature of bubbles. In this letter, we explain how the global financial inflation has come about and what its dire implications are for investors and world economies.

CARNAGE

The Fed's quarter-point hike in its funds rate on February 4, 1994 apparently caught the world financial community — including its smartest traders — sleeping at the switch. What was supposed to be a fillip for the markets, so the Fed and others thought, may prove to be the infamous needle pricking the bubble.

Since October 1993, long-term interest rates in the U.S. have risen from a low near 5.8% to a recent high in excess of 6.80%. Triggering enormous losses for overleveraged speculators, it has caused a daisy-chain reaction in all other financial markets, and is a far cry from the soothing message that Wall Street greeted the New Year with: "Low inflation and low interest rates as far as the eye can see." Wall Street and the markets had feasted on this rosy certitude and concluded that the "best of all possible worlds" was ahead for the financial markets.

It was not to be. More recently, once the decline in the U.S. bond market gathered momentum in February, it quickly spread to other markets . . . even the supposedly robust, hard-currency bond markets. European and Japanese bond markets suffered sizable losses. Emerging country bond markets virtually collapsed, some falling more than 15% in less than three weeks. (Table I on the opposite page lists the scale of the losses for various markets from their recent peaks.) Given the global scale of this bubble, no market escaped.

These quicksilver market reactions betray and expose what we have been warning about for a long time: That a great speculative bubble has been founded on extreme illiquidity. How can that be? Isn't that a contradiction in terms? Weren't markets, as the brokers told us, liquidity-driven? Readers of past letters already know how that can happen.

Recent developments also expose the total confusion in the markets. The fact that an itsy-bitsy rate hike — and not even a discount rate hike at that — is now blasted as the culprit behind the bond disaster shows ignorance and a total inability to recognize a bubble. Originally, we recall, the rate hike was met

with near universal praise in the belief that it would actually have the opposite effect on long-term interest rates. A supposed "preemptive strike" against inflation was supposed to convince financial markets that low inflation was here to stay.

LOOKING FOR A TRIGGER

In retrospect, perhaps sometime in the future after a full-blown financial bust has run its course, the lessons of history will seem more obvious. The present great bubble has had all of the classical ingredients — greed, illusions and delusions. But for now, the delusions still seem to prevail: that there is no inflation; that low inflation guarantees low interest rates; that the financial bull markets are liquidity driven and other sundry mistaken beliefs.

RECENT SECURITIES MARKET TRENDS

Stock Markets	Recent High	Recent Low	% Decline
France, CAC 40	2355.9	2144.7	-9.0%
Germany, DAX	2268.0	2020.3	-10.9%
Hong Kong, Hang Seng	12201.1	9877.4	-19.0%
Japan, Nikkei 300	306.8	298.1	-2.9%
U.K., FT 100	2520.3	2146.5	-14.8%
Malaysia, KLSE Composite	1586.3	1314.5	-17.1%
Mexico, IPC	2881.2	2514.2	-12.7%
U.S.A., Dow Jones Industrials	3978.4	3824.4	-3.9%
10-Year Bond Futures, March			
France	131.2	125.1	-4.7%
Germany	101.4	96.6	-4.7%
U.K.	120.1	111.2	-7.4%
U.S.A.	116.0	110.0	-5.2%
Japan	118.3	110.2	-6.9%

And so, commentators are bound to disagree over the causes and implications of the recent bond disaster. Many bank and broker analysts — the notorious professional bulls — have been quick to discard it as just a long-overdue correction that will soon right itself once the excellent underlying fundamentals are again recognized. According to some of them, lower rates are likely — new lows, in fact — later in the year.

We think that too many of these "experts" don't have the faintest inkling of the nature and fantastic scale of the speculative bubble that's overhanging the fragile world economy presently.

A SHORT HISTORY OF THE BUBBLE

In order to determine what will happen next, it is important to understand how the markets got into such a mess in the first place. This latest saga started almost five years ago. To recall, when the U.S. economy began to weaken in the course of 1989, the Greenspan Fed lowered its Fed funds rate from almost 10% in mid-1989 to just over 8% by the first half of 1990. Once it was learned that this cautious easing failed to prevent a recession, the Fed stepped on the accelerator more forcefully. By early 1991, the Fed funds rate had fallen to 6%.

Late 1990 was the key starting point for the speculative frenzy in the financial markets. Faced with a very sluggish economic recovery — far below cyclical norms — and a tottering financial system, the Fed threw caution to the wind and opened its money spigots as never before. While at the same time flooding the banking system with reserves, it proceeded to slash its Fed funds rate to 3% by early July 1992.

The crucial consequence of the artificially low short-term interest rates was a monstrously positive yield curve, the steepest since the 1930s. It beckoned the financial community to a collective, reckless financial orgy. Thousands of banks, brokers and other institutions that had access to funds at the super-low money market rates embarked on a fantastic binge of yield-curve playing. Their huge bond purchases, in turn, caused long-term interest rates to tumble.

In the case of the U.S. bond market, it was easy enough to track the build-up of this bubble in the Fed's Flow-of-Funds statistics. Banks and brokers, the two biggest groups of players, now hold leveraged bond portfolios amounting to around $1.1 trillion. Approximately $450 billion of this position was accumulated during the last three years. These purchases alone, as we've pointed out in previous letters, financed more than 50% of the Federal budget deficit during this period.

Colossal as these figures are, the yield-curve playing by other institutions was enormous as well, although harder to detect and track in the available statistics. This is particularly true for the speculative activities carried out through the international markets. Last, and certainly not least, are the huge speculative activities implemented through derivatives instruments — futures, options, over-the-counter options, swaps and their myriad combinations. There is very little information available that sheds light on the scale of these speculative activities through the derivative markets. Nevertheless, there is enough anecdotal information to know that it is enormous, in fact, involving sums many times the transaction of all other markets. Rumours sweeping the markets that U.S. brokers and hedge funds (a misnomer, these are really gambling funds) were forced to close out huge positions in European bonds (much of these held through derivative holding strategies) in order to stop losses, testify to the large influence of these activities.

<u>NO CRASH INSURANCE</u>

Considering the colossal U.S. bond holdings of American banks and brokers, it seems obvious that the biggest of all bubbles is in the U.S. Treasury market. Here, the financial intermediaries suffered the biggest losses, naturally hitting the banks and brokers the worst. In many cases, the bond losses were compounded by big currency set-backs since U.S. banks, brokers and hedge funds had also heavily shorted the yen. They had expected it to weaken on the back of widening U.S.-Japan interest rate differentials in favour of the dollar.

Instead, President Clinton's Japan-bashing caused the dollar to plunge against the yen. At the same time, the major European currencies, which also were forecast to fall against the dollar, are now trading near or above their levels of the past half-year. As can be seen, bond and dollar speculation badly misfired both at the same time.

A third big shock happened in the futures markets where events dramatically reconfirmed a nasty lesson from the 1987 crash: namely, that hedging with futures doesn't work when it's needed the most. The sophisticated financial theories that the math doctorates — the "quants," as they are called — have popularized on Wall Street during the past half-decade have again malfunctioned. "Tracking risk," to use one of their technical terms (the great fear of these theorists) struck again.

Caught on the wrong foot, too many bond speculators tried to hedge (offset their risk) in the future markets, and in doing so, started a price spiral in the "cash markets." Inundated with one-sided sell

orders, future prices sagged sharply relative to those in the cash markets putting further pressure on the latter. Therefore, in extremely thin markets, the cost of hedging soared. Essentially, the resulting gap between futures and cash prices, encouraging extensive arbitrage promoted massive purchases of futures, matched by corresponding sales in the cash market, the two pulling each other downward.

THE PROGNOSIS: BUST OR TEMPORARY SETBACK?

So much for the recent past. In the aftermath, we are left with two paramount questions. The first one concerns the recent bond market rout: Is it just a mere accident or simply a correction in an ongoing bull market, or is it the start of something much more serious and bearish for stocks and bonds alike? Most worrisome is the second big question: How will a pronounced downdraught in stock and bond prices impact the real economies?

Though history never precisely repeats itself, we like to study it for guidance. With respect to crashes, there are two dramatic examples that had opposite effects on the economies — the big stock market crashes of 1929 and 1987. The latter one, the steepest of the postwar period, had no significant effect on the economies. By contrast, the crash of 1929 did lead to an economic meltdown.

Generally speaking, we would say that the final outcome in each case simply depended on the vulnerability of the financial markets, on one hand, and the economies, on the other. The effects of the 1987 crash soon dissipated because it hit a very strong world economy on the verge of a new boom. By contrast, the 1929-crash had devastating economic effects because it struck a foundering, fragile world economy, thus turning an impending recession into a prolonged depression. Which brings us straight back to the question of the nature of the recent financial boom: Is it a speculative bubble, and therefore prone to burst one day, or not?

It's definitely a bubble, we think, and one that's becoming increasingly dangerous the longer it lasts. As we said, we think chances are that the bubble has begun to burst. But most experts are just as fully convinced that the booming markets are a natural outgrowth of healthful developments. A secular decline in inflation and interest rates, a secular portfolio shift out of deposits into securities, and a secular redistribution of incomes away from wages and towards profits through job shedding, downsizing and re-structuring, are all pointed to as constructive and positive developments. And together, these three ostensibly healthy and lasting shifts in the economic and financial structure are believed to assure permanently higher valuations of financial assets.

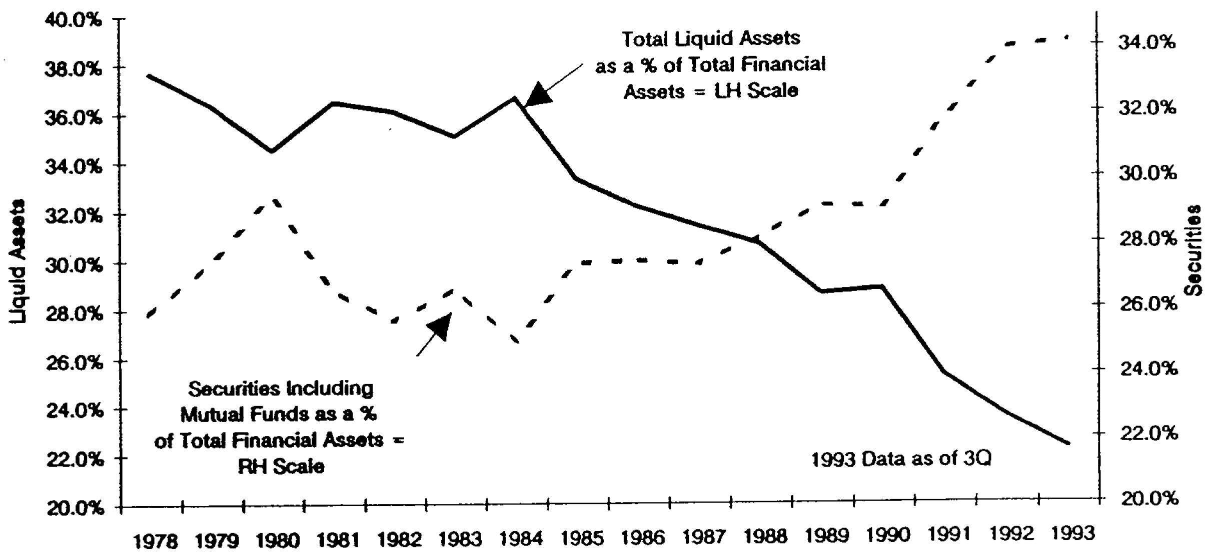
THE THREE FALLACIES

As "old-timers" in economics, we have to say that every bit of Wall Street's bull story (and London's, too, for that matter) is pure hogwash. Still, these false theories promising safety and guaranteed higher returns have lured millions of savers into investments that expose them to risks they are not accustomed to. And because these nonsense theories found such widespread gullible belief, it became a self-fulfilling prophesy . . . at least, temporarily.

Just how valid are these "consensus" theories? First of all, to us, to relate long-term interest rates simply to inflationary expectations, is ludicrous. It implies the absurd: that monstrous budget deficits and paltry savings are completely irrelevant to interest rate levels. Obviously, they are not.

No less ludicrous is the exuberant appraisal of the big switch from bank deposits into stocks and bonds, the biggest on record in the U.S. The following graph shows the enormity of this shift. Of course, while it occurs, this migration of capital nicely buoys the securities markets, but it disregards the adverse flip side of this shift: namely, a record deterioration in household liquidity. Deposits, as a percent of disposable income, have fallen to the lowest level in 30 years. Liquid assets have fallen to less than 22% of total financial assets held by individuals, also the lowest on record. (See Chart below.) Just think of it: Since their peak in February 1991, small time deposits have fallen almost $400 billion. This surely speaks of growing and dangerous illiquidity.

U.S. INDIVIDUALS: SHIFT IN FINANCIAL HOLDINGS
% of Total Financial Assets, Annual



Source: Board of Governors of the Federal Reserve

Just as absurd and delusionary is the general glorification of job shedding, downsizing and restructuring. These measures are presented as the hallmarks of economic revitalization as once-sluggish enterprises whip themselves into shape for the new era of global competition. Whatever benefits single companies may reap from this pursuit, for businesses and the economies in the aggregate, it spells inexorable erosion of long-term growth. Recent modest cyclical improvements in U.S. productivity and profits only temporarily mask clearly deteriorating trends over the long-term.

THE GLOBE IN FOCUS: NO ROSY PICTURE

Our misgivings about the current global financial boom really start with our highly critical assessment of all those glittering, fake, "new era theories" that seem to justify an endless rise in stock and bond valuations. Every one of them is utter humbug in our eyes. In reality, it's worse than humbug because, knowingly or unknowingly, these theories serve to delude and deceive millions of investors about the true risks and eventually will cause them to lose a sizable part of their savings. Actually, it fits the regular pattern of manias that those individuals who are most closely involved — the professionals who ought to know better — concoct new crackpot theories that foretell of a new era in which old economic laws no longer apply.

Looking at the world economy, we still see budget and trade deficits of unprecedented size. Critical, as well, is a worldwide slump in investment. And unfortunately, we don't see any meaningful improvement in these internal and external imbalances and excesses.

In past letters, we have extensively addressed the deeper-seated causes of the present world economic malaise in the industrial countries. In contradiction to the complacent consensus view, we have always stressed that it will take many years to work off the appalling financial and economic distortions that have accumulated in the world as a consequence of the credit and debt excesses of the 1980s. Even this view presupposes that the problems are being properly addressed. And we are by no means convinced of that.

In our view, the most dangerous of modern myths is the widespread, blind belief that central banks can cure all and any economic pain by the simple expedient of cutting interest rates. To the contrary, the hard truth is that the greatest financial and economic disasters in history have generally been courted by prolonged periods of abnormally low interest rates. Rather than curing economic ills, it invoked huge speculative bubbles. It may lessen the apparent pain over the short-run, but it most certainly worsens the long-term, terminal outcome. Easy money, over the long-run, is not the panacea it is generally thought to be.

THE COST OF LOW INTEREST RATES

To hear it from economists and money managers, there is no price to pay for super-low, short-term interest rates. It seems none of them is aware of Japan's recent, ill-fated experience with super-low interest rates that led to its asset bubble of the late 1980s and also the disaster of the U.S. stock bubble of the late 1920s.

Common to both of these financial asset bubbles, was that the following crashes were harbingers of deep, prolonged downturns for the economies. At the root of Japan's bubble, from early 1987 to early 1989, were two years of super-easy money and super-low short-term interest rates at around 3% which launched frantic credit and broad money growth.

While Japanese consumer price inflation persisted well below 2%, the excess money from the credit inflation largely poured into domestic and foreign asset markets. In Japan, land and stock prices virtually exploded. But given the low consumer price inflation, this price explosion in the asset markets was generally viewed with acquiescence. Rather, the world financial community hailed the astronomic price-earnings ratios that became commonplace in the Tokyo market as the emblem of Japan's virility and super-strong economy. More than anything else, it was the low inflation rate that gave rise to a false sense of security about the boom. As long as consumer price inflation was low, it was reasoned, there can be no excesses and risks of higher interest rates.

The bursting of the bubble was ushered in with the arrival of a new governor at the Bank of Japan in early 1989, Mr. Mieno. He focused on the soaring land and stock prices, decrying it as "*asset price inflation*" and a speculative bubble. He believed that it would be better to puncture it before it burst of its own accord even more violently and from more extreme levels of over-valuation, risking untold damage to the banking system and the economy.

Despite continuing low inflation rates, the Bank of Japan successively raised its discount rate between May 1989 and August 1990 from 2.5% to 6%. Even though the Tokyo stock market suffered a steep slide during 1990, the central bank remained confident of being able to manage a soft landing for the economy. Many clung to the comforting notion that the excesses of the bubble economy were somehow distinct and separate from the real economy.

The Japanese economy then abruptly slowed in mid-1990, and subsequently, in mid-1991, began a steep decline. Its major causes were plunging business investment and exports, associated with a general profit collapse smacking of depression. The important point to see, though, is that Japan's present extraordinary economic and financial difficulties are directly related to the previous speculative bubble and its bursting. Excessive monetary ease and super-low interest rates usually have an enormous cost.

Obviously, undeterred by Japan's disastrous boom-bust experience with super-low interest rates, the Federal Reserve has repeated the same mistake during the last two years. Remarkably, it has happened with very much the same effects — relatively weak effects on the real economy contrasted with hyper-stimulative effects on the financial markets.

WHO CAN SEE A BUBBLE?

We still wonder what the true motive of the Fed's recent mini-rate hike was: insurance against an overheating economy or against overheating financial markets? To begin with, did the Fed ever realize that it was nurturing a global financial mania that was rivalling Japan's bubble? As it was happening, few people were able to grasp the enormity of the bubble and its eventual potential disastrous implications, not only for the financial markets themselves, but for the world economy.

It really testifies to an unbelievable ignorance on the part of the world financial community. How miserable it is that these so-called experts failed to realize the nature of this boom though it was plainly visible in the official U.S. monetary statistics, in particular, as we pointed out, in the Fed's very detailed Flow of Funds Accounts.

What makes a bubble? The common symptom of a bubble are unusually high valuations. But what causes this symptom? Here, the key gauge is the sources of the funds flowing into the markets because they are the underlying cause. In this last analysis, the crucial test is distinguishing between new savings and "inflation" derived fund flows.

It used to be conventional wisdom that capital values or the level of long-term interest rates in a country are determined by the supply of new savings — more precisely, by available savings relative to credit demand and asset supply. Today, nobody looks at savings any more. The popular explanation for the steep decline in long-term interest rates were super-low and falling short-term interest rates, excess liquidity, falling inflation and sluggish credit demand. Savings dynamics were completely ignored.

THE SOURCE OF BUBBLE

In general, private credit demand around the world is extremely weak. Budget deficits, however, loom large as never before. Combined, the two still add up to pretty strong overall credit demand. The bottom line of it all, however, is that in many countries, total credit demand is running far in excess of

current domestic savings. The infallible, telltale sign of such savings shortages are the big current-account deficits of many countries.

Take the U.S.: It's full of absurdities and contradictions. As we have repeatedly explained, the global bubble is primarily driven and lubricated by American money. But where has all of this money come from in the U.S.? Definitely not from a savings boom. New personal savings, the normal source of investible funds, have been running at an annual rate of less than $200 billion. The savings ratio is near its all-time low, and according to the latest figures for January, continues to weaken.

A look at U.S. credit, savings and money flow data is illuminating and provides some insight into the enormity of the speculative bubble. We shall focus on the last three years — from 1990 to 1993. During this period, available new household savings totalled about $620 billion. Business savings, in the form of undistributed profits, amounted to about $130 billion. But total domestic credit expanded by $1.6 trillion during this period. Within this total, Treasury and agency bonds accounted for more than $1.2 trillion. That's a staggering gap between savings and credit growth. Yet, interest rates plummeted.

As unbelievable as that is, it's not the end of it. At the same time, investors poured an additional $900 billion into equities and mutual funds. Lately, a significant portion of this flow has rushed into foreign markets. Ironically, though the U.S. doesn't have enough savings to fund its own budget deficit, U.S. money has elevated financial markets throughout the world.

Where then did this huge ocean of money deluging the financial markets come from if not from an excess of savings? Where could it come from? On this question, as we so often do, we consulted the books of the great economists of times past. Many of them did a lot of thinking on the topic of the sources of money flowing into financial markets and economies.

One of them, the late Professor Gottfried Haberler, a personal acquaintance of ours, put his finger on the answer. In his book, Prosperity and Depressions, he says the following: *"The supply of investible funds may be said to flow from three sources —from amortisation quotas, from new savings and from 'inflation' in the broad sense (including not only newly created money, but also withdrawals from existing hoards of money)."*

Since the capital expenditures of U.S. corporations in the aggregate currently exceed their cash flow, we can disregard "amortisation quotas" as a potential source of investible funds. That leaves us with two other originators of investible funds — savings and "inflation". Since we have already determined that it is not savings, the source therefore must be the "inflation" Haberler describes.

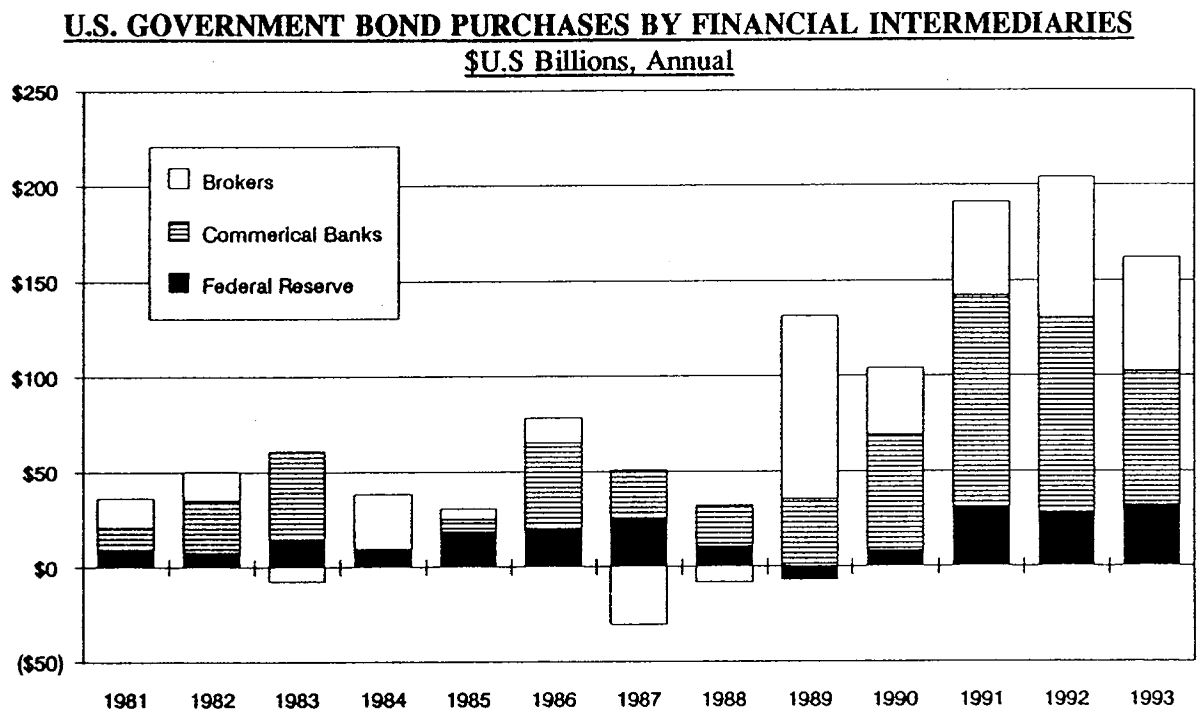
Bubbles are made by money that comes from inflationary sources. Haberler continues his analysis with this further explanation: *"There are various inflationary sources of supply — the central bank, the commercial banks, and, last but not least, the liquid reserves (hoards) in the hands of business firms and individuals."* With this, he actually expressed a view which was shared by the leading economists of Europe at that time.

TRACKING DOWN INFLATION

The primary source of inflation in every economy, of course, is the central bank . . . the Federal Reserve

in the case of the United States. For its part, it purchased $90 billion of government bonds during the past three years.

But the Fed does not directly increase the money supply all by itself. It creates new deposits to the credit of its member commercial banks — so-called bank reserves. The increase in the money supply, measured by the different M's, comes about as the rising supply of reserves induces the banks to expand their bond holdings or loans. Generally, the size of these purchases are many multiples of the reserve injections. As it happened, the banks added more than $270 billion in bonds to their balance sheets over the three years 1990 to 1993. (See the chart below.)



Source: Board of Governors of the Federal Reserve

We now come to the third big source of the bond market bubble, one which Haberler doesn't mention because it has never played such a big role as today. It's the additional yield-curve playing activities of the non-banks — brokers, pensions funds, hedge funds, corporations and rich private individuals. Like the banks, they have built up huge bond portfolios financed at the low "repo" interest rates. Most of this money is borrowed through the money markets from other non-banks, corporations and financial institutions.

This part of the speculative bubble is difficult to verify statistically. But without question, in the order of magnitude, it amounts to many hundreds of billions of dollars. There is one group for which these figures are available — the security dealers and brokers. In late 1993, they alone held a bond position of almost $300 billion, half of which they accumulated during the past three years.

This massive yield-curve playing by the non-banks has one important peculiarity. Unlike the activities of the banks, it does not result in deposit or money creation. Rather, it's a game that is played with

existing bank deposits. These are shuffled among the participants, facilitating massive institutional bond speculation. In this last analysis, the existing money stocks are more intensively utilized. Expressed in more conventional words, money velocity is increased.

But the biggest source of the bubble by far is what Haberler calls "*withdrawals from existing deposits*" or what we otherwise might call dishoarding. It's the mass exodus of individual investors out of bank deposits and money market funds into stocks and bonds, largely through mutual funds. These investments, nearly $1 trillion, are the most tragic and malicious part of the bubble. The responsibility for this lies with the Fed and the many financial institutions, who in their drive for profits, lured millions of savers with "sugar plum" dreams of prosperity and financial gains. Many of these individuals, deprived of interest income, were only too vulnerable to the claims of safety and guaranteed high returns. Little did they know that they were assuming high risk. For the most part, they still don't know.

A SCARCITY OF LIQUIDITY

As to the monetary implications of such a portfolio shift — namely the use of existing money for the purchase of stocks and bonds — in textbook terms it is referred to as dishoarding, increasing money velocity, liquidity preference and the like. The key point is that these stock and bond purchases essentially leave the broad money supply unchanged. The demand deposits that are employed do not vanish; they simply become the property of mutual funds, for example.

All these monetary technicalities may appear complicated and boring. Yet, they are crucial to understanding the true cause of the recent panic sell-off in the world's financial markets. The true causes of the near-crash are all found in the preceding speculative orgy which drove markets to extreme valuations, absurdly out of kilter with the enormous imbalances between the supply and demand for savings.

Since June of 1993, an apparently inexhaustible supply of money from American investors and highly-leveraged speculators flooded global financial markets, pushing prices upwards in an almost vertical trajectory. As we said in earlier letters, America exported its bubble. Remarkably, however, U.S. stock and bond prices began to lag during this time. In fact, the bond market already peaked in October of 1993.

In our view, the mild Fed tightening on February 4, 1994 was the inert catalyst that punctured the bubble. It is in the nature of financial manias that virtually anything unexpected can trigger its collapse.

This leaves us with two questions of paramount importance: Now following the sell-off, is it reasonable to expect that the speculative froth is out of the markets? Second, could the bond disaster spill over into the stock markets and possibly undermine the world economic recovery?

To the first question, our short answer is a definite "no". This speculative bubble is far too big for it to be liquidated within a few weeks. The huge overleveraged bond portfolios of the banks, investors and speculators, running into the hundreds of billions of dollars, are the Damocles sword hanging over the markets. Who out there is able or willing to bail them out? Any rally, therefore, is bound to invoke more liquidations.

If U.S. bonds continue to weaken, as we assume in view of the appalling imbalances that we have described, it looks very black for the share markets, too. In fact, a long-term bear market may have already begun. Watching recent market action, we suspect that there have been secret interventions in the stock futures to prop up the U.S. share market, much as occurred in October 1987.

As to the second question, fearfully, this time it won't be like 1987. When the financial markets melt down, the economy will not be spared. In this respect, we tend to draw some comparisons with the crash of 1929 that deeply worry us: First, far more household wealth is tied up in the markets today than in 1987 (again see the chart on page 6); second, this is the biggest financial bubble in history taking on global proportions. There is no such thing as a purely national stock market any more. In 1929, Wall Street's crash didn't lead to an immediate worldwide collapse. This time around the implications of such an event are much larger. Third, the U.S. economy is much weaker and more vulnerable than in the late 1920s. The main positive difference between then and today is that we start from a much higher level of prosperity.

CONCLUSIONS

Liquidity, liquidity, liquidity! Nothing else matters. Currency recommendations, economic forecasts . . . it's all secondary right now. This is not the time to invest, but to liquefy.

It's a curious thing, liquidity. It can't be had when everybody wants it. It's only available cheaply when its held in disdain. To this point, few have wanted it . . . in fact, people have run from it. As we've outlined, liquidity is at its lowest on record.

Given the inordinate risks in global financial markets, capital preservation remains the overriding objective. Investors should only focus on short-term, cash-equivalent securities.

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